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MasterCard Agenda Item 9

September 15, 1992

Peter S.P. Dimsey
President
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To: MasterCard International U.S. Region Board of Directors

From: Peter S.P. Dimsey

Subject: Response to a Report Distributed to the Visa U.S.A. Board

A confidential "analysis" of MasterCard's strategy by Visa management (attached) has come to my attention which was distributed to the Visa U.S.A. Board of Directors in June, 1992. This report makes many wildly inaccurate statements about our actions and intentions, and I feel compelled to go on record and correct them. I take particular exception to the assertion that MasterCard's actions threaten the profitability of members. Most important, however, I believe that the recommendations made in this report are blatantly self-serving to Visa and, if acted upon, are likely to harm rather than help members.

The background section of Visa's report depicts MasterCard's position in 1990-91, and it accurately notes that at that time MasterCard had experienced a long period of share decline. However, contrary to what is stated in the report, three years ago MasterCard's management and Board of Directors adopted a strategic plan whose five key goals were to:

1. Strengthen the MasterCard brand through value-focused advertising and marketing programs, as well as by updating our brand mark.

2. Improve service to our members through well-staffed regional offices.

3. Develop programs to increase member profitability, including investments in state-of-the-art systems.

4. Launch a merchant acceptance initiative to maintain unsurpassed acceptance for MasterCard.

5. Create a global POS debit system.

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In contrast to Visa's claims, each of these strategic goals, and the subsequent actions which MasterCard has taken to achieve them, were designed for the sole purpose of creating a platform for long-term profitable growth for our members. These five strategic goals are a matter of public record. They have been shared with our Board, Committees and Councils, and have been outlined in considerable detail in our annual reports, our speeches and in the press.

The Visa report then goes on to make a number of other unsubstantiated and plainly erroneous statements which I will address as follows:

- <u>MasterCard's decentralized system architecture is highly competitive with Visa's centralized architecture</u>.

  With a 99.999% availability record, Banknet, by design, is more flexible and reliable than VisaNet. Contrary to the assertions in the Visa report, MasterCard provides unsurpassed risk identification and excessive chargeback monitoring services; our chargeback reduction program has made MasterCard's rate of chargebacks the lowest in the industry; and Project Omni will soon deliver account tracking services. For the future, we believe that Banknet will continue to provide levels of service and efficiency which is equal or superior to VisaNet, because we do not need to spend such vast sums on supercenters and hardware.

- <u>Visa's lead in off-line debit is not a reflection of relative brand strength</u>.

  Instead, it's a reflection of a large number of brokerage cards issued under the Visa brand, a direction that Visa has now reversed. MasterCard believes the real opportunity in debit is in an on-line product, through differentiated branding to the consumer and separate cost-based pricing to the merchant.

- <u>MasterCard's partnership strategy is a major advantage for our members</u>.

  For example, outside the United States, MasterCard's partnership with Eurocard is developing into a position of great strength in Europe, as evidenced by our strong leadership position in Germany. Similar strong partnerships have led to leadership positions for MasterCard in Brazil (Credicard) and Argentina (Argencard). All of these partnerships have supported the interests of traditional banks, in contrast to Visa's alliances with non-banks in these markets. Given the increasingly nationalistic sentiments in Europe as well as in other parts of the world, our partnership strategy offers great potential for MasterCard in both credit and debit. The benefits of these partnerships accrue to all MasterCard cardholders, who are assured of unsurpassed levels of acceptance, no matter where they travel.

- The interests of the MasterCard and Visa Boards are fundamentally identical.

  Consistent with the relative size of the two organizations, 4 out of the 10 largest banking institutions are members of the MasterCard Board. MasterCard would welcome members from any of the remaining six. The majority (62 percent) of our board's aggregate credit card volume is from "traditional" banks and our board's interest in the success of *both* brands is substantial - 35 percent of our board's volume is on Visa cards. Also, our "non-traditional" board members believe just as strongly as any of our "traditional" members do in both building a strong MasterCard brand for all MasterCard members and in maintaining a level, competitive playing field as two fundamental requirements for the profitable growth of their institutions. As a board, it has tried to deal with the realities of a changing marketplace, and does not view it as a virtue to exclude from its membership any members or potential members who are highly supportive of the MasterCard brand.

  So much for the misassumptions about our situation in 1990-91. The Visa report then lists their version of our strategies in order to attack them. I have already listed our five major strategic goals on the front page of this letter. Let me deal with the wild accusations that are raised in regard to Visa management's version of our strategies.

- MasterCard has made sizable and prudent investments in systems development.

  Spending vast sums of money neither guarantees a better payment system nor does it provide a better return on our members' investment. Rather, MasterCard has sought to maximize the effectiveness of the dollars we spend. MasterCard took a long look at outsourcing, but concluded that we couldn't realize sufficient cost savings from it and were genuinely worried about loss of control. Instead, we entered into a strategic venture with AT&T Business Systems and NCR, leaders in the telecommunications industry. As a result, MasterCard remains in total control of its network. It is illogical to suggest that this venture would enable AT&T to establish a competing brand system - why would MasterCard plan itself out of business?

- MasterCard's increased investment in marketing has been very effective in strengthening the brand to the benefit of members.

  MasterCard's brand image ratings have improved, and our member mail response rates are at least as good as Visa's. The increase in our advertising spending was fully justified by nearly two years of successful in-market testing. Our change of advertising agencies will lead to even greater opportunities. In addition, the *MasterValues* program is strongly supported by members and has demonstrated its ability to build usage. Contrary to the allegation in the report, we have never paid any merchant to participate. Finally, we significantly increased our Member Relations staffing over the past three years in response to member requests. The result is that members say that we are providing vastly improved service which, in many cases, is better than Visa's. I encourage you to ask your own staff whether they see this as a good investment by MasterCard.

- MasterCard's affinity and co-branding rules are designed to increase our members' opportunities for profitable growth.

  As the credit card market has matured, the emphasis has shifted from card growth to share competition. It has become increasingly important to differentiate products based on added value, whether through price, quality or added benefits. We support co-branding as a means of allowing members to add value, whether through affinity programs; through co-branded programs such as the frequent flyer programs; or through programs such as the recently announced GE Rewards and GM MasterCard cards. These programs will also compete very effectively against outside competitors, particularly Discover.

  The only differences between MasterCard and Visa on the subject of co-branding are, first, our support of co-branding as a strategy and, second, our allowance of a second account number. We proposed allowing the use of second account numbers as a means of enabling members to gain access to the huge base of single purpose cardholders. However, since there hasn't been a single program that has utilized this benefit since the rule was passed in November 1990, we are re-evaluating its effectiveness. Furthermore, since November 1990, when our co-branding rules were clarified, 77 percent of all co-branded programs have been with so-called "traditional banks."

With regard to the AT&T Universal program, it is well known that Visa's management helped them set up the program. I would simply like to point out that while Visa has effectively "grandfathered" all existing co-branded programs initiated prior to February 1992, MasterCard requires *all* co-branding programs, regardless of when they were initiated, to come into compliance. This applies to AT&T, who because of our insistence, is in the process of consolidating their MasterCard accounts in banks owned by them. AT&T is also proactively supporting a program to open telephone acceptance to all MasterCard members. This, we believe, is the right interpretation of a "level playing field" for all members.

- <u>A distinctive but related logo for Maestro will strengthen the MasterCard brand.</u>

  The integration of the signage of MasterCard, Maestro, and CIRRUS will simply increase MasterCard brand equity. MasterCard believes that the members will be served best by providing them with the opportunity to participate in the best global payment system as represented by a family of distinct but related payment products — MasterCard, CIRRUS, and Maestro. These are different products and services and need to be differentiated to consumers and merchants. However, MasterCard's highly recognizable interlocking circles enable these brands to be linked together in order to build synergy from the strength that each brings. Our research supports this conclusion, and this is a marketing strategy frequently used by the leading branded-goods and services companies. Most objective observers think our approach is brilliant.

- <u>We will win the on-line debit race, and we will do so to the benefit of our members.</u>

  It's hard to believe that Visa is serious in claiming that the Maestro program risks loss of bankcard profitability, loss of market control, and degradation of MasterCard brand equity. Maestro was developed by members and regional EFT networks to provide the most efficient way of developing on-line debit. It builds on the network's existing structures, which translates into much lower start up and connectivity costs. Banks set-up the regional networks to facilitate EFT (both ATM and POS). They have been successful in managing ATM growth, and we look forward to similar success on the POS side. We believe on-line debit will be far larger than off-line debit because members can issue it to all their DDA customers. Because it will be initially accepted primarily by merchants who do less credit business, we believe that on-line debit will be much more complementary to credit then off-line debit. This is supported by the Interlink experience, where the volume is still overwhelmingly in supermarkets and gas stations.

Visa concludes their report by suggesting that they will need to devote more resources to competing with MasterCard because of our lack of concern over the future of the bankcard business. This is absurd. The fact is that over the last four years MasterCard has rededicated itself to providing members with what they want - a strong bankcard brand which is differentiated from Visa. We have strengthened our brand; we are serving members better; we are implementing programs that increase member profitability; and we are introducing new products that will provide them with profitable growth opportunities. In trying to divide members to choose between brands, Visa will reduce your choice and your ability to be competitive.

The truth is that having enjoyed a long period of supremacy over MasterCard, Visa management is finding that they are under greater pressure to perform. That may make it more difficult for them, but it is a far better situation for members. The availability to our members of two strong bankcard brands is the major benefit of duality.

I hope that my response has helped you understand that Visa has given you a very distorted and inaccurate depiction of MasterCard and its strategies. I encourage all members to let the business interests of their institutions be the determinant of whether or not they support MasterCard. I hope they will not be motivated by this attempt to create fear by means that border on the dishonest. I am convinced that all members will be better served if they have two strong associations to choose between. You have the assurance of Pete Hart and myself that we believe in our mission - "to be the world's best global payment franchise by providing the best value to cardholders and merchants, and superior profit growth opportunities for members" - and we will continue to be guided by it.

Sincerely,

Peter S.P. Dimsey
President
U.S. Region

Note: This report is considered highly confidential and is being distributed only to Visa's Board of Directors and senior management. Directors are requested to limit distribution of this summary within their institutions and not to provide a copy to any third party.

Visa U.S.A. Board of Directors
June, 1992

MasterCard Strategic Analysis Summary

Background:
MasterCard has fielded a new set of strategic initiatives in the past two years which threaten future bankcard profitability for Members.

In order to understand why MasterCard would pursue strategies which are not in the best long term interests of Members, it is necessary to recognize the business situation MasterCard management faced, and the composition of the MasterCard Board, as of 1990-91 when the new strategies were developed and approved.

MasterCard's market position in the credit card market was eroding rapidly in the U.S. under prior, more Member benefit-oriented, strategies.

	Share of Total Market Sales Volume		
	1987	1990	Change
Visa	41.1%	44.7%	+ 3.6 pts.
MasterCard	28.4	26.4	- 2.0 pts.

	Millions of Gold Cards Issued		
	1987	1990	Change
Visa	5.0	17.6	+ 12.6M
MasterCard	6.3	13.6	+ 7.3M

MasterCard had also lost the off-line Debit race that the two associations began simultaneously in 1988. Members preferred to issue only one brand of Debit, and the stronger Visa brand was more attractive to them.

	Millions of Debit Cards Issued		
	1988	1991	Change
Visa	6.6	9.3	+2.7
MasterCard	1.0	1.6	+ .6

By 1990, it had also become apparent that MasterCard's decentralized system architecture was not competitive with Visa's centralized architecture. It does not permit review of transactions at a central point.

Thus it cannot perform services like Risk Identification, Excessive Chargeback Monitoring, Chargeback Reduction, and Account Tracking.

Looking to the future, MasterCard's System cannot gain the efficiencies of Supercenters, nor can it provide the major Member cost savings of programs like Backoffice 2000 or Payment Service 2000.

The MasterCard delivery system was also based on obsolete Series One technology, no longer supported by IBM, while Visa had already made the investment necessary to evolve to a PC based system.

It would have cost MasterCard an estimated $100 million to achieve Systems parity with Visa in 1991, and an additional $150 million by 2000.

MasterCard has another major disadvantage versus Visa outside of the U.S. The MasterCard logo remains subordinate to partner logo's such as Eurocard and Access, despite an attempt to fix this situation by converting to a new MasterCard logo globally in 1989-90. Given the rapid growth forecast for overseas markets, this disadvantage was likely to become more important in the 1990's.

Any new strategies would need to be approved by MasterCard's Board, which, prior to last month, was comprised of both U.S. and non-U.S. Directors. If you look at U.S. Board Members only, composition differences versus the Visa Board help to explain why the MasterCard Board would vote differently on key issues.

MasterCard's U.S. Board tended more towards smaller issuers, at least as regards traditional banks. MasterCard's board also differs from the industry norm and from Visa's Board in having a card portfolio skewed towards MasterCard. Finally, MasterCard's U.S. Board membership is heavily oriented towards non-traditional banks.

	MasterCard Board	Visa Board
Brand volume of Board Members	$24 B	$68 B
% Board portfolio in Visa	38%	66%
% Board portfolio in MasterCard	62%	34%
% Board sales - Traditional Banks	45%	97%
% Board sales - Non-Traditional Banks	55%	3%

Manufacturers Hanover has since left the MasterCard Board, while AT&T has joined other non-traditional banks on this Board like USAA, MBNA, Colonial, Household, and Monogram. Thus, non-traditional banks now represent an estimated 74% of the total MasterCard sales done by MasterCard U.S. Board Members.

New MasterCard Strategies:
(1) Minimize investment in systems development.
(2) Increase emphasis on Marketing.
(3) Use Partnerships to maximize short-term business growth.
(4) Use Maestro to achieve global brand unity.
(5) Win the on-line Debit race, no matter the cost.

Assessment of Member Benefits and Risks:

Minimize investment in systems development.
This frees up the $250 million MasterCard would have to invest to achieve systems parity with Visa, and is being done via outsourcing. The overall MasterCard system is reportedly being outsourced, in parts or its entirety, as "Project Omni". The on-line system for Maestro is being outsourced to Deluxe Data Systems.

The principal benefit to Members is the avoidance of an investment to achieve systems parity with Visa.

The principal risks to Members are the loss of control over the MasterCard system and the "enabling" given to a potential competitor.

AT&T and its NCR subsidiary are the first partners MasterCard has announced for its Project Omni outsourcing, and it is rumored that AT&T will be MasterCard's primary outsourcing candidate.

If a company like AT&T gains control over MasterCard's systems, the value of Member's Visa system will be reduced by the existence of a "parallel railroad" controlled by third parties. Member control over the MasterCard system will be reduced as the outsourcing partners gain greater control over system policies and pricing. Perhaps most concerning, establishment of the Universal card as a competing brand will be facilitated.

Increase Investment in Marketing Support
The principal benefit to Members is that MasterCard will be able to compete more effectively against Discover and American Express and, with duality, many Members do not view a market share shift from Visa to MasterCard as a threat.

The principal risks to Members are an inefficient use of their overall association marketing funds and an increased cost of doing business over the long term. (The risks of a Visa share shift to MasterCard will be discussed later in this document.)

MasterCard is increasing spending behind their current advertising by $10 million, despite the fact that the ineffectiveness of this advertising has led to a search for a new advertising agency. Members are spending at least as much in total, and far more per dollar of sales or per card, on this campaign as on the highly effective and efficient Visa campaign.

MasterCard is placing part of these funds into staffing up their marketing efforts directed to Members, which does not return any additional profits to the Members. For example, they have 50% more field people in Member Relations.

A side-by-side comparison of this year's annual reports for the two associations is a demonstration of how MasterCard is directing more of its revenues against marketing to Members as opposed to focusing efforts on marketing for Members

They are also increasing spending against Merchant Relations, but are not spending these funds as efficiently as Visa. The incremental Member profits generated by the MasterValues promotion are not believed to offset the costs of this promotion, while Visa's merchant promotions are returning $2-4 of incremental Member profits for every $1 invested.

This is in part because MasterCard is paying merchants high fees just for cooperation with MasterValues. As an example, K-Mart and Melville Corporation were reportedly each offered a $1 million cooperation fee, over and above the cost of the MasterValues promotion. This practice is encouraging merchants to request exorbitant fees for their cooperation in joint promotions with bankcards and will likely drive up the cost of doing business for both associations over time.

Use partnerships to maximize short-term business gains.

The principal Member benefit of this strategy is that it maintains MasterCard as a viable brand, maintaining the benefits of duality for Members. Without significant new volume from sources outside the traditional bankcard industry, it is somewhat questionable how long MasterCard could remain a viable major brand.

The principal Member risks are reduced volume and profits, and reduced ability to influence market developments for the original owners of the two bankcard associations.

One source of this risk relates to MasterCard's relatively relaxed rules on membership and affinity card programs. For example, AT&T, now a Mastercard Board members represents 5% of the total bankcard market, with 90% of the Universal cards issued in 1991 having been Mastercards.

The other risk relates to bankcard profits being siphoned from Members via MasterCard's aggressive pursuit of co-branded cards with "split transactions". MasterCard permits transactions on these cards to be treated as a merchant's private label card transactions when they occur in that merchant's outlets. Members do not get interchange or outstandings, but presumably keep the expense and risk of merchant failure or chargebacks. The small fee MasterCard charges for the merchant to maintain a separate account number on these cards does not fully offset the loss of revenues from the split transactions.

It is likely that MasterCard's aggressive pursuit of this market will accelerate the development of split transaction co-branded cards. The net result will be MasterCard market share growth at the expense of Member profits.

Use Maestro to achieve global brand unity.

The principal U.S. Member benefit is that MasterCard will become more visible overseas, perhaps yielding more MasterCard transactions when cardholders travel internationally. This assumes that the move to a common use of the interlocking circles logo design for Maestro, MasterCard and Cirrus is successful at convincing Eurocard and Access to subordinate their logo's to the interlocking circles design.

This unification of MasterCard, Eurocard and Access efforts is believed to be a prime motivation for Maestro's program design

The principal Member risk is loss of MasterCard brand equity. The consumer image and appeal of the MasterCard brand may be significantly weakened by its association with an inherently weaker class of products.

Win the on-line Debit race, no matter what the cost.

The principal Member benefit is the availability of a second on-line debit bankcard option for those Members that are not willing to commit to Interlink alone.

The principal Member risks are loss of overall bankcard profitability, loss of market control, and degradation of MasterCard brand equity over the long term.

MasterCard is emphasizing Maestro over off-line debit products, potentially shifting the market towards a less profitable type of product

Maestro's retail pricing has been set so low as to encourage merchants to install on-line terminals that will shift credit and off-line debit transactions towards less profitable on-line debit products.

MasterCard's experience in off-line Debit, where they have lost the race to Visa by a significant margin, is believed to be the reason why Maestro's product design and pricing are influenced more by the desires of regional switch operators than by the best long term interests of Member institutions. Regional Switches have votes equal to Issuers/ Acquirers on the Maestro Board. Regional Switches have historically been oriented towards transaction volume, not overall card program profitability.

Accommodating Regional Switches has also led to Maestro service levels being set based on ATM models, not on the needs of merchants and consumers at the point of sale -- e.g., a 25 second authorization time for supermarkets. This may degrade the service quality image of the overall MasterCard brand over time, damaging the image of the parent brand in which Members have invested so much money.

Maestro is positioned as an international product. However, it is also being positioned to Members in the U.S as PIN-based and to European Members as signature-based. This compromise is advantageous to MasterCard's European Members, but it is damaging to U.S. Members. U.S. Issuers are at risk when they issue cards assuming the control of PIN-based authorization, but the cards travel overseas.

Risk of Visa Market Share Losses to MasterCard:

Even with duality, any loss of Visa market share to MasterCard as a result of these new strategies represents risks to Visa Board banks and the financial institutions they represent.

As market share shifts from Visa to MasterCard, influence over the future of the bankcard industry shifts from Visa's Board to MasterCard's Board. The MasterCard Board has demonstrated less concern over the future profitability of bankcards in recent years. It is increasingly dominated by non-traditional banks that do not necessarily share the interests of the traditional banks which make up the bulk of Visa's Membership.

MasterCard's Board and management have also demonstrated a lack of responsiveness to the desires of Visa Board banks (membership rules, mention of Visa in Gold Card TV advertising, etc.). This lack of responsiveness is despite the fact that Visa's U.S. Board Members account for as much MasterCard volume in the U.S. as do MasterCard's U.S. Board Members.

As Visa loses its market share advantage over MasterCard, it will be forced to devote more of its resources to competing with MasterCard. This reverses a trend which has permitted Visa to focus increasingly more resources on activities which build overall bankcard volume and reduce Member costs.

Loss of market share also reduces Visa's leverage with merchants, making it more difficult and expensive to conduct volume building activities.

It has historically proven less expensive for brands to sustain marketplace momentum than to regenerate lost marketplace momentum, especially for brands which hold a significant market share lead over their nearest competitor.

Principles For A Visa Defense

Visa's Debit Strategy must succeed in the market. This requires the support of Visa's Board .

Visa must maintain market share leadership, with MasterCard gains among non-traditional issuers, affinity cards and co-branded cards offset by Visa gains among traditional issuers. This requires stronger marketing programs to Members, merchants and consumers. Programs which incent Member loyalty to Visa and "disincent" support for MasterCard's strategies may be appropriate.

Visa must become increasingly differentiated from MasterCard. This would require that dual Visa and Mastercard Members would have to yield efficiencies in the way they manage these two brands. However, this loss of efficiency may be justified in order to gain superiority on Visa over a Mastercard which is increasingly dominated by non-traditional banks and split-transaction co-branded programs.

Visa must maintain a Systems advantage for our Membership, despite MasterCard's System outsourcing to AT&T and others. This would involve permitting Visa to exploit its Systems advantages and shifting transactions towards the Visa System.

Note:
The Visa Board can direct Visa's efforts to defend the interests of the overall Membership. However, any actions which any financial institution may take to defend against the threats from the new MasterCard strategy must be taken individually and must be based on the best interests of that individual institution.

Bradford W. Morgan